BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

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NEBRASKA PUBLIC SERVICE COMMISSION

In the Matter of the Nebraska Public Service Commission, on its own motion, to make adjustments to the universal service fund mechanism established in NUSF-26.	)	Application No. NUSF-50
In the Matter of the Commission, on its own motion, seeking to determine the level of the fund necessary to carry out the Nebraska Telecommunications Universal Service Fund Act.	)	Application No. NUSF-4

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a true and correct copy of the attached Pre-Filed Direct Testimony of Kevin J. Kelly was hand-delivered or sent via regular U.S. Mail, on this 29th day of September, 2006, addressed as shown below, to the following:

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DIRECT PRE-FILED TESTIMONY OF KEVIN J. KELLY

Introduction

Q. Please state your name and business address.

A. My name is Kevin J. Kelly. My business address is: 1465 Kelly Johnson Blvd., Suite 200, Colorado Springs, CO 80920.

Q. By whom are you employed and in what capacity?

A. I am the Director of Regulatory Services at TCA, Inc. – Telcom Consulting Associates ("TCA"), a telecommunications consulting firm. TCA provides financial, regulatory, marketing and management consulting services to rural telecommunications providers.

Q. Please summarize your educational background and professional experience.

A. Prior to joining TCA in 1997, I was employed by two regional CPA firms -- Kiesling Associates and Frederick & Warinner – both of which specialized in the auditing of rural telephone companies; Sprint, in tax and general accounting positions for multiple affiliates; the Kansas Corporation Commission, as a Managing Regulatory Auditor; and Overland Consulting, a regulatory consulting firm.

In addition to participating in several prior Nebraska proceedings, I have also participated in regulatory proceedings in Colorado, Wyoming, Kansas, Oklahoma, Missouri, Idaho, California, New Jersey, Utah and Minnesota. Several of these proceedings have required testimony.

I received both a Bachelor of Business Administration, with an accounting major, and a Masters in Business Administration, with an emphasis in finance, from the University of Iowa. I hold the Iowa Board of Accountancy Certified Public Accountant Certificate No. 3455.

Q. On whose behalf are you presenting testimony?

A. I am testifying on behalf of the Rural Telecommunications Coalition of Nebraska[1] ("RTCN"), which consists entirely of incumbent local exchange carriers ("LEC") providing basic local exchange and other telecommunications services to rural Nebraskans. All of the members of the RTCN have been designated Nebraska Eligible Telecommunications Carriers ("NETC"), a status that provides access to support from the Nebraska Universal Service Fund ("NUSF").

Background

Q. Please briefly summarize the history of this proceeding.

A. On January 18, 2006, the Nebraska Public Service Commission ("Commission") opened the above-captioned docket, to consider certain adjustments to the permanent NUSF mechanism established in NUSF-26.[2] Specifically, the Commission sought comment on several possible alternatives for reducing NUSF distributions – an action necessitated by its earlier decision to reduce the fund surcharge.[3] Interested parties filed initial comments on April 14, 2006 and reply comments on May 12, 2006. Based upon these comments, the Commission Staff developed its proposal ("Staff Proposal") for reducing NUSF distributions. On July 18, 2006, the Commission invited interested parties to comment on the Staff Proposal. Based upon comments filed from interested parties, the Staff Proposal

[1] The Rural Telecommunications Coalition of Nebraska ("RTCN") includes Arapahoe Telephone Company d/b/a ATC Communications, Benkelman Telephone Company, Inc., Cozad Telephone Company, Curtis Telephone Company, Dalton Telephone Company, Diller Telephone Company, Glenwood Telephone Membership Corporation, Elsie Communications Inc., Hemingford Co-operative Telephone Association, Hartman Telephone Exchanges Inc., Keystone-Arthur Telephone Company, Mainstay Communications, Plainview Telephone Company, Southeast Nebraska Telephone Co., Wauneta Telephone Company, and WesTel Systems f/k/a Hooper Telephone Company. The RTCN was formerly known as the Nebraska Independent Coalition for Embedded-Based Cost Support ("NICE-BCS").

[2] *See In the Matter of the Nebraska Public Service Commission, on its own Motion, Seeking to Establish a Long-Term Universal Service Mechanism,* Application No. NUSF-26, entered August 21, 2001. ("*Permanent NUSF Docket*")

[3] *See* Application No. NUSF-4, ORDER SETTING SURCHARGE, entered July 6, 2005. Effective October 1, 2005, the Commission reduced the NUSF surcharge from 6.95 percent to 5.75 percent.

was further modified. The Commission also established a proposed timeline which called for testimony and a hearing on the Staff Proposal with the goal of implementing the changes by January 1, 2007.

Q. Has RTCN been an active participant in this proceeding?

A. Yes. RTCN members receive a substantial portion of their revenues from the NUSF. Significant reductions in these revenues could result in reduced levels of capital expenditures, service quality and other rate increases. Accordingly, RTCN has previously filed comments on three separate occasions in this proceeding in an effort to insulate their customers as much as possible from a negative outcome.

Q. Please summarize RTCN's advocacy in this proceedings.

A. RTCN has consistently advocated that the Commission should only modify its long-term NUSF distribution mechanism -- the Support Allocation Methodology ("SAM") – as a last resort. Upon its adoption the Commission found that the SAM met the objectives of the NUSF, which was to provide sufficient and predictable support to carriers providing universal service in high-cost areas of Nebraska. RTCN asserts that it is more appropriate to modify the transition mechanisms before making changes to the SAM. RTCN has also expressed concern about the proposed imputation of federal universal service support into the NUSF distribution mechanism – a position previously rejected by this Commission. Furthermore, RTCN contends that the Commission should defer the creation of any new NUSF program, which will result in the diversion of significant funds from current recipients until after it has ensured that the current NUSF is on solid financial ground. Finally, RTCN recommends that the Commission reconsider its decision to reduce the NUSF surcharge, which appears to be necessary to ensure that the providers of universal service receive sufficient support.

SAM Allocations

Q. Please explain why the SAM should only be modified as a last resort.

A. The Commission, along with numerous other interested parties, spent almost four years in developing a long-term distribution mechanism for the NUSF in accordance with both the Federal Telecommunications Act of 1996 and the Nebraska Telecommunications Universal Service Fund Act. Upon adopting the SAM as the long-term mechanism to distribute NUSF support, the Commission found that:

> The proposed methodology for the calculation of support is specific, sufficient, and predictable consistent with Neb Rev. Statue § 86-323. The proposed methodology highly targets support to the most costly and sparsely populated out-of-town areas where support is needed. The methodology specifically pinpoints the support areas and provides companies with a specific model for determining the amount of support available for distribution[4]

Additionally, the Commission also found that:

> The SAM is practical, manageable, flexible, and focuses support to the high-cost areas in Nebraska. The SAM provides a fair and reasonable process in which to allocated NUSF support to NETCs providing support to high-cost areas.[5]

Accordingly, RTCN strongly recommends that the Commission use the SAM to allocate the maximum amount of NUSF support possible.

Q. Does the Staff Proposal allocate the maximum amount of NUSF by using the SAM?

A. No, it does not. The Staff Proposal reduces the amount currently allocated by the SAM from $65 million to $44.7 million – a 35% reduction.

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[4] See *Permanent NUSF Docket*, Findings and Conclusions, entered November 3, 2004, para.11

[5] *Ibid.*, para. 49

Q. Isn't it necessary to reduce to the support allocated via the SAM to balance NUSF receipts and disbursements?

A. No, it is not. Some of the confusion on this critical issue revolves around the distinction between the *allocation* and the *distribution* of NUSF. For example, while the SAM *allocates* $65 million in NUSF, it is *distributing* less than $46 million in 2006. The remaining funds are distributed via one of the three transition mechanisms created upon the Commission's adoption of the SAM.

Q. Could the NUSF be appropriately reduced without changing the amount of support allocated by the SAM?

A. Yes, it appears that it could. Retaining the SAM allocation at $65 million (the initial allocation) in the model in the Staff Proposal results in a distribution of NUSF of only $39 million to recipients, which is less than the approximate $44.7 million of NUSF that the Staff Proposal envisions distributing.

Q. Will this reduce the amount of NUSF that will be distributed through the three transition mechanisms?

A. Yes, it will.

Q. Why is it more appropriate to reduce the NUSF allocated by the transition mechanisms instead of the amount allocated by the SAM?

A. The Commission found that the SAM was the most appropriate manner in which to allocate NUSF to eligible recipients. The transition mechanisms were established to enable an orderly transition from the interim NUSF allocation methodology to the SAM. Accordingly, the Staff Proposal should reflect the Commission's clear preference for the SAM as the method to distribute NUSF.

Q. Are the three transition mechanisms equal in importance.

A. No, they are not.

Q. Please elaborate.

A. The first two transition mechanisms were created to address specific public policy concerns. The first transition mechanism – the NUSF 7 Waiver – ensures that carriers making substantial facilities upgrades during the development of the long-term NUSF mechanism will be provided a continuing opportunity to recover the cost of these investments. The second transition mechanism – the Per-Line Backstop – provides an annual limit in the amount of NUSF support a recipient can incur in a single year as a result of the conversion to the SAM from the interim distribution mechanism. By establishing a maximum loss of NUSF on a per-line basis, this treats large and small recipients in an equitable manner.

Q. Could the Commission retain its existing allocation in the SAM and fully fund the first two transition mechanisms?

A. Yes. Increasing the SAM allocation in the model contained in the Staff Proposal to $65 million results in the distribution of $41.3 million in NUSF -- more than $3 million less than the total distribution in the Staff Proposal. In other words, the Commission could retain its existing SAM allocation and the first two transition mechanisms and still have a balance of approximately $3 million in NUSF.

Q. Please explain why the third transition mechanism less important than the others.

A. While the first two transition mechanisms had specific purposes, the third transition mechanism - the Over-Earnings Reallocation ("OER") – is merely a distribution of excess support that eligible recipients are not yet able to retain.[6] The Commission justified the OER as follows:

> To begin with, the Commission finds the baseline support allocation is sufficient. Secondly, the OER mechanism redistributes over-earnings. The OER does not cause a company to face a reduction in their baseline support; rather, the OER has the effect of *increasing* support due to the over-earnings of other companies. If companies are

[6] The Commission found that once companies have fully invested in their networks that there will be no over-earnigns to reallocate.

> properly investing in their network, the Commission will not have any over-earning dollars to redistribute. *In the alternative, the Commission could have decided to redistribute the over-earnings to consumers.*[7]

In other words, the SAM allocation provides sufficient support, and the OER simply allocates (temporarily) excess support. By lowering the NUSF surcharge, the Commission did exactly what it identified as the alternative to the OER – redistribute excess NUSF to consumers.

For this reason, RTCN strongly contends that retaining the existing SAM allocation and reducing the OER distribution is the most appropriate manner by which to resolve the current dilemma facing the NUSF (distributions exceeding receipts). This avoids changing the SAM, while retaining the necessary protections for recipients incurring substantial reductions in NUSF resulting from the transition from the interim to the long-term mechanism.

FUSF Imputation

Q. Do you agree with the FUSF imputation contained in the Staff Proposal?

A. No. To the extent I have correctly replicated the calculation contained in the Staff Proposal, it appears that FUSF imputation is much more than depicted. Instead of merely allocating federal high-cost loop support to the state jurisdiction, it appears that the Staff Proposal simply allocates all interstate earnings in excess of the interstate authorized rate-of-return to the state jurisdiction. In other words, the Staff Proposal has eliminated the ability of many NUSF recipients to report earnings on a state-only basis.

Q. Does the FCC provide rural LECs with the opportunity to earn in excess of its authorized return in the interstate jurisdiction?

A. Yes. Similar to large LECs who operate under a price-cap regime in the interstate jurisdiction, the FCC provides rural LECs the ability to adopt various forms of

[7] *Ibid.*, para. 12 *(emphasis added).*

incentive regulation. FCC rules allow rural LECs to exit the NECA access pools and file company-specific access rates.[8] While these rates must be calculated using the authorized interstate rate-of-return of 11.25 percent, there is no pooling of revenues, and carriers, if they are able to control costs or increase access minutes, can earn above the authorized interstate return. However, these returns are not guaranteed and rural LECs that are unable to control costs or who lose access minutes will likely earn less than the authorized interstate return. The FCC's average schedule formulas are another form of incentive regulation available to rural LECs in the interstate jurisdiction.[9] This provides rural LECs the ability to recover interstate access costs based upon a proxy of the average costs of other similarly-situated rural LECs. Depending upon the rural LEC's actual costs, it has the opportunity to earn in excess of the interstate authorized return or the risk of earning less than the authorized return.

Q. Should these interstate earnings be used to reduce a recipient's NUSF support?

No. Many of these carriers have reported earnings on a state-only basis for many years – an option provided by the Commission at the creation of the NUSF.[10] More importantly, this option should not be eliminated on a retroactive basis as envisioned by the Staff Proposal. This impacts decisions made and risks taken many years ago.

Q. Do you have other concerns regarding the effective elimination of these interstate incentive regulation options for rural LECs?

A. Yes. These interstate incentive regulation options can in many instances be short-term. Accordingly, any rural LEC incurring a reduction in NUSF resulting from

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[8] § 61.39

[9] § 69.606

[10] *See In the Matter of the Nebraska Public Service Commission, on its own Motion, Seeking to Conduct an Investigation into Intrastate Access Charge Reform,* Application No. C-1628, Findings and Conclusions, entered January 13, 1999, pg. 8.

interstate earnings levels must be allowed to re-establish support at levels specified by the SAM.

Benchmark Local Rates

Q. What is your reaction to the increase in benchmark local rates contained in the Staff Proposal?

A. I have several concerns with increasing local benchmark rates. First, Nebraska residents already pay rates more than ten percent above the national average for local service.[11] Second, the FCC is considering substantial changes to the current intercarrier compensation regime.[12] These proposed changes include increases to the federal subscriber line charge, which will further increase the cost of monthly local service to Nebraska consumers. Accordingly, I would strongly encourage the Commission to exercise extreme caution in further increasing the local service benchmark to ensure affordability of service.

Q. Do you agree with the Staff Proposal to adopt different benchmark rates for rural and urban consumers?

A. No. High cost funds should be used to equalize rates between high-cost rural customers and lower cost urban customers. While the statutory requirement is for reasonably comparable rates, many state commissions (including Nebraska) have generally interpreted this equate to identical rates. Furthermore, charging different local rates for customers of the same small rural LEC (depending on whether the customer resides inside or outside the city limits) will increase administrative costs, result in customer confusion and ultimately create resentment among customers.

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[11] *See The Commission on its Own Motion, to Make Adjustments to the Universal Service Fund Mechanism Established in NUSF-26,* Application No. NUSF-50, P.O. No. 1, Reply Comments of the Rural Independent Companies (RIC), pg. 9. RIC quantifies the minimum local service charge for Nebraska residential customers as $27.99 versus the national average of $24.31.

[12] *See Public Notice,* Comment Sought on Missoula Intercarrier Compensation Reform Plan, CC Docket No. 01-92, DA 06-1510 (rel. July 25, 2006)

Wireless Fund

Q. Should the Commission delay the establishment of a separate wireless infrastructure fund?

A. Yes. It is crucial that the Commission stabilize the existing NUSF before establishing new programs which will divert the flow of funds required by current recipients. Furthermore, the NUSF currently provides support to qualified recipients on a competitively-neutral basis.[13] In other words, wireless carriers already have access to the NUSF should they choose to seek it.[14] The current lack of demand for NUSF support by wireless carriers leads me to question the need for the proposed wireless infrastructure program.

Q. Is this lack of demand for access to state high cost funds by wireless carriers unique to Nebraska?

A. No. While wireless carriers continue to request access to the federal universal service funds at an increasing rate, requests by wireless carriers for access to state high costs throughout the nation have virtually ceased.[15] Even more amazing, wireless carriers who have been granted access to state high cost funds have on occasion simply not requested the funds to which they are entitled.[16] The only rational conclusion that can be drawn from this is that that wireless carriers have determined that compliance with the requirements for access to state high-cost funds outweigh the benefits. Accordingly, before allocating a significant portion

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[13] See *Permanent NUSF Docket*, Findings and Conclusions, entered November 3, 2004, para. 14-17

[14] While other competitive carriers have sought and received access to the NUSF, no wireless carrier has sought access.

[15] Wireless carriers requesting and receiving federal ETC status has continued to grow at an increasing rate. According to the USAC Report HC01, wireless ETCs have increased from a handful in 2001 to over 500 in 2006. While many of the early requests from wireless carriers for federal ETC designation also included a concurrent request for access to the state high cost funds, RTCN is not aware of such a request since August 2000.

[16] Western Wireless (since acquired by ALLTEL) was granted access to the Colorado High Cost Support Mechanism in November 2002. For reasons unstated, it has never requested eligible support, which has been estimated by CPUC Staff to exceed $30,000 per month. Furthermore, the CHCSM is not a dedicated fund as envisioned by the Staff Proposal, but simply provides the competitive carrier the identical per-line support received by the incumbent.

of critical NUSF support away from the high-cost program to a wireless infrastructure program – complete with the attendant responsibilities that must accompany access to support mechanisms -- the Commission should ensure that the demand actually exists. Finally, I would encourage the Commission to defer any allocation to a dedicated wireless program until after the conclusion of the ongoing proceeding investigating this matter.[17]

Surcharge Increase

Q. Does the reduction in NUSF envisioned by the Staff Proposal raise concerns regarding the sufficiency and the predictability of the NUSF?

A. Yes. The magnitude of the reduction in the NUSF high cost program -- $20 to $25 million – could seriously jeopardize the sufficiency of support for the providers of universal service, as required by Nebraska statute.[18] Less than two years ago the Commission established the SAM and found that it distributed NUSF in a sufficient and predictable manner. Reducing the fund size by approximately one-third as envisioned by the Staff Proposal certainly raises questions concerning both the predictability and sufficiency of support.

Q. Do you recommend the Commission reconsider its decision to reduce the surcharge?

A. Yes. At a minimum, the Commission should adopt the surcharge increase identified in the Staff Proposal (from 5.95 to 6.25 percent). This would enable the Commission to avoid additional reductions in NUSF distributions of almost $7 million. Additionally, future changes in the surcharge should be in response to the maintenance of a NUSF that provides sufficient and predictable support, not vice versa. Finally, I would recommend the Commission consider more frequent modifications to the NUSF surcharge to ensure that the receipt of contributions

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[17] *See In the Matter of the Nebraska Public Service Commission, on its own Motion, Seeking to Investigate Issues Related to Providing Dedicated Universal Service Support for Wireless Telecommunications Services,* Application No. NUSF-48/PI-104, entered August 9, 2005.

[18] *See* NEB. REV. STAT. § 86-323

closely approximates the distributions of support. More frequent changes to the surcharge would reduce the magnitude of the required change and would likely result in surcharge increases as well as decreases. For example, it is very possible that an increase to the surcharge in this proceeding could be a temporary fluctuation, as proposed changes in the federal intercarrier compensation regime could produce an additional source for NUSF receipts.[19]

Q. Does this conclude your testimony?

A. Yes, it does.

[19] One of the features of the Missoula Intercarrier Compensation Reform Plan is the creation of an "Early Adopter Fund" which provides federal support to state high cost funds (such as the NUSF) implemented for the purpose of reducing intrastate access rates. These additional funds enable the surcharge of the state high cost fund to be reduced.